

Insight Talk Show

Conversations with CalPERS Leaders

Edition Title: Investment Update

Insight Host: Bob Burton

Guest: Joe Dear, CalPERS Chief Investment Officer

Bob Burton:

Welcome to Insight, a program designed to keep you up to date on CalPERS issues. One of the most important issues at CalPERS will always be the health of the Pension Funds Investments. Who better to examine that issue for us than Joe Dear, CalPERS Chief Investment Officer. Joe welcome back to Insight.

Joe Dear:

Hi Bob, glad to be here.

Bob Burton:

Over the course of the downfall of the markets two years ago, CalPERS took a pretty big hit but things have improved. How do we stand?

Joe Dear:

We've come a long way back Bob. From the low point in March 2009 our assets were 165 billion, we're moving up towards 240 billion today. Our investment loss was 24% in 2009, which is a huge hit to take for a large investment program. Since that time we've had double digit returns. So we are improving steadily.

Bob Burton:

Concerned about unfunded liability and pension sustainability, making headlines all over the country, continues to do that. Are the investments of CalPERS going to keep the fund healthy?

Joe Dear:

Yes they are. But think about the liabilities this way Bob, you know if, it's like a mortgage, right? Now, if you had to pay your mortgage off today, you'd have a problem. But, if you can make the monthly payment, you're fine. So the pension liabilities are the same way. They're enormous, but if we can make the investment return we need steadily over time, we'll be able to meet that liability. And that's the essence of the approach that a long horizon investor like CalPERS has and that's why I'm confident we'll succeed.

Bob Burton:

Last December, the Board took a look at developing a program moving forward of assessing risk and economic growth and the determination of our investment plans. How's it going to affect what we do investment wise?

Joe Dear:

The impetus of the new approach to asset allocation to focus on risk characteristics first not on asset characteristics, so don't look just at equity's, fixed income, real estate, private equity, but look at what is the exposure of these

Insight Talk Show

Conversations with CalPERS Leaders

kinds of assets to economic growth to liquidity concerns and to inflation and that gives us a risk centric focus to the portfolio. One of the lessons of the crisis was we all need to improve our risk management, both the quantitative tools we use and importantly the qualitative tools we use, or the judgment we apply. So one of the impacts of applying those lessons to CalPERS, was to change the frame of reference. Again, to the risk characteristics that are in the portfolio. What does that mean in practical terms? Well we collapse a distinction between private equity and public equity. But private equity is essentially just like public equity exposed to economic growth. It just has a longer time horizon because it's less liquid. Real Estate has components of equity like growth, has income and inflation protection growth. And then the liquidity bucket, as we call it, the provision we have to help us ride out the needs for cash if things get really bad, is just that, it's protection against the consequences of poor or really negative economic growth in the portfolio. So this will help guide how we do our investment policies and investment practices for the next decade or so.

Bob Burton:

We've seen some recovery happily but there's still issues out there like oil prices and jobs and housing market that's still suffering. Against that backdrop, what do you see in the way of continued growth?

Joe Dear:

Well, I consider myself to be a wary optimist. I know in the long term things will be okay. I feel pretty good about the short term. It's this intermediate term where there's so many variables and uncertainties that we have to pass through. So what about the near term? Yes, there are really significant problems in the economy. Housing prices continue to fall and the job picture is still awful for those out of work. And the recovery in jobs is much slower than we'd like it to be. At the same time, corporate profits are solid and corporations have a lot of cash to invest and to put to work. Export markets are doing better primarily in part because the dollar has come down. So there're bright spots in this economy as well. Equity values for the long term are driven by growth and productivity improvement, and that's a positive picture for us. Now again I said the long term will be fine. The intermediate term has a lot of issues where you just don't know what the outcomes will be. Will the United States get the fiscal issues around spending and revenue resolved? Well we hope so but you don't know. What will happen in the Middle East? Will the political instability resolve itself in a way that provides steady access to Middle East oil which is so important, or will something happen there? What about the European banks? Will the banking crisis there be resolved successfully or will there be further pressure and potential real risk to the world financial system. Don't know the answers to any of those they have to play out so those are the things you have to be mindful of. But what do we know about our economic system? We know it has cycles. We know things get good for a while and people get very optimistic, and then things turn and they get bad and people get very pessimistic. And one of the things a long horizon investor like CalPERS can do is keep that long term perspective and stay calm, be

Insight Talk Show

Conversations with CalPERS Leaders

patient, stick with the plan, and we know over time the economy will grow and we will produce decent investment returns.

Bob Burton:

With that infinite number of variables to assess, what are the most promising areas for CalPERS Investments?

Joe Dear:

Well we like to think about strategic strengths, our long horizon, our balance sheet, and our ability to write big checks to make large investments that other investors can't do. Then as I mentioned we're changing the strategy in terms of making it a much more risk centric focus in the investment operations and in the management operations. We're so big we're not going to be able to trade our way to lots of advantages. We have to be patient long term investors. Where do you see opportunities emerging markets over the long term. Prices are high now, but emerging markets we expect a huge increase in the number of middle class consumers in China, India, Indonesia, Brazil, and around the world. So you'd want to capture some of that growth. There are opportunities in technology through our clean tech investments that we think will help, we hope, capture the values that will be created as we transition to more sustainable forms of energy. And trading opportunities that exist by finding the best managers with the best strategies, and being very flexible about how they approach their investment mandates.

Bob Burton:

A few months ago you expressed some concern that recovery as welcome as recovery is might tend to dull the enthusiasm for market reform. Are you still concerned about that at this point?

Joe Dear:

I'm very concerned. Congress in 2010 passed a Dodd-Frank Act which was about as good a reform of the financial system as one could expect, and the most significant rewrite of financial regulatory laws since the great depression. Since that time the regulators have been working to implement the act and we've watched those who were dissatisfied with the statutory outcome in congress tried to unwind through regulation the protective measures of that bill. But here's what concerns me most. We knew right after the crisis that something terrible would happen and that even proponents of deregulation recognize that there were things about the financial market that were assumed that they in effect could be self-regulating, which were not true. And for a while everybody said that's clear we need to re-regulate. Two years later, economies doing okay, financial markets doing quite well, and the critics of regulation are taking advantage of people forgetting the painful experience we had when the regulatory system failed, and using that to attack the regulatory system with the same arguments they did arguing for deregulation before the crisis. I'm very concerned that we're going to get seduced by this, this comforting way of, if we don't regulate the

Insight Talk Show
Conversations with CalPERS Leaders

economy growth everything will be fine. We know for sure that when financial systems go bad, it's not just the people investing in those markets who are hurt, it's everybody and we are still paying a huge price for that failure.

Bob Burton:

So you see it as very much a work in progress.

Joe Dear:

It's very much a live issue today.

Bob Burton:

Alright Joe, thank you so much for making time for us today, we really appreciate it here.

Joe Dear:

Great to be here Bob. Thank you.

Bob Burton:

You've been watching Insight: Conversations with CalPERS Leaders. Our guest today was Joe Dear, CalPERS Chief Investment Officer. Join us again soon for more Insight.